# $H_2O$ ENTERTAINMENT CORP.

**Consolidated Financial Statements**

For the years ended December 31, 1998 and 1997

DICK COOK SCHULLI
*Chartered Accountants*

# AUDITORS' REPORT

**To the Shareholders of $H_2O$ Entertainment Corp.**

We have audited the consolidated balance sheets of $H_2O$ Entertainment Corp. as at December 31, 1998 and 1997 and the consolidated statements of loss and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the corporation as at December 31, 1998 and 1997 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Dick Cook Schulli
CHARTERED ACCOUNTANTS

Calgary, Alberta
April 23, 1999

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*Professional Corporations*

# $H_2O$ ENTERTAINMENT CORP.

## Consolidated Balance Sheets

As at December 31, 1998 and 1997

| | 1998 | 1997 |
|---|---|---|
| **Assets** | | |
| **Current** | | |
| Cash | $ 90,531 | $ 24,886 |
| Accounts receivable | 145,121 | 9,557 |
| Income taxes recoverable | - | 48,475 |
| Work in progress | 100,060 | - |
| Prepaid expenses and deposits | 26,606 | 13,107 |
| | 362,318 | 96,025 |
| **Goodwill** – Note 2 | - | 198,000 |
| **Capital** – Note 3 | 540,770 | 466,995 |
| | $ 903,088 | $ 761,020 |
| **Liabilities** | | |
| **Current** | | |
| Accounts payable and accrued liabilities | $ 95,915 | $ 30,790 |
| Shareholder advances – Note 4 | 355,524 | 56,478 |
| | 451,439 | 87,268 |
| **Shareholders' Equity** | | |
| **Share capital** – Note 5 | 2,125,577 | 1,788,077 |
| **Deficit** | (1,673,928) | (1,114,325) |
| | 451,649 | 673,752 |
| | $ 903,088 | $ 761,020 |

**Approved by the Board:**

____________________, **Director**

____________________, **Director**

*See accompanying notes*

# $H_2O$ ENTERTAINMENT CORP.

## Consolidated Statement of Loss and Deficit

For the years ended December 31, 1998 and 1997

| | 1998 | 1997 |
|---|---|---|
| **Revenue** | | |
| Royalty income | $ 1,109,731 | $ 1,458,623 |
| Costs of developing games | 789,972 | 1,253,867 |
| | 319,759 | 204,756 |
| **Expenses** | | |
| Amortization - game development assets | 182,030 | 133,150 |
| - capital assets | 32,194 | 25,657 |
| - goodwill | 66,000 | 66,000 |
| - goodwill impairment | 132,000 | - |
| Administration and investor relations | 182,933 | 187,587 |
| Research costs | 183,900 | 373,250 |
| | 779,057 | 785,644 |
| **Loss before income taxes** | 459,298 | 580,888 |
| **Income taxes** – Note 7 | 100,305 | - |
| **Net loss** | 559,603 | 580,888 |
| **Deficit,** beginning of year | 1,114,325 | 533,437 |
| **Deficit,** end of year | $ 1,673,928 | $ 1,114,325 |
| **Loss per share** | $ 0.05 | $ 0.06 |

*See accompanying notes*

# $H_2O$ ENTERTAINMENT CORP.

## Consolidated Statement of Cash Flows

For the years ended December 31, 1998 and 1997

| | 1998 | 1997 |
|---|---|---|
| **Cash provided by (used for):** | | |
| **Operating activities** | | |
| Net loss | $ (559,603) | $ (580,888) |
| Amortization | 412,214 | 224,807 |
| | (147,389) | (356,081) |
| Net changes in non-cash working capital items | (135,513) | (56,810) |
| | (282,902) | (412,891) |
| **Financing activities** | | |
| Issue of shares | 337,500 | 140,607 |
| Shareholder advances | 299,046 | 56,478 |
| | 636,546 | 197,085 |
| **Investing activities** | | |
| Capital assets acquired - administrative | (207,850) | (239,548) |
| - game development | (80,149) | (3,585) |
| | (287,999) | (243,133) |
| **Increase (decrease) in cash** | 65,645 | (458,939) |
| **Cash,** beginning of year | 24,886 | 483,825 |
| **Cash,** end of year | $ 90,531 | $ 24,886 |

*See accompanying notes*

## Note 1 - Significant Accounting Policies

The financial statements of the corporation have been prepared in accordance with generally accepted accounting principles. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of periodic financial statements necessarily involves the use of estimates and approximation. The financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

### (a) Consolidation

The consolidated financial statements include the accounts of $H_2O$ Entertainment Corp. and its wholly-owned subsidiaries, $H_2O$ Entertainment Ltd. and $H_2O$ Design Inc.

### (b) Capital assets and amortization

Capital assets are recorded at cost. Amortization of these assets is provided using rates designed to amortize their cost over their estimated useful lives at the following annual rates:

| | |
|---|---|
| **Development equipment:** | |
| Computer hardware | 30% declining balance |
| Computer software | 50% declining balance |
| Sound and audio equipment | 30% declining balance |
| **Other:** | |
| Automotive | 30% declining balance |
| Office furniture and fixtures | 20% declining balance |
| Leasehold improvements | straight-line over lease term |

In the year of acquisition, amortization is reduced by one-half.

### (c) Goodwill

The excess of cost over net identifiable assets acquired on the reverse takeover of $H_2O$ Entertainment Corp. is capitalized and was being amortized on a straight-line basis over a period of five years. The corporation evaluated the recoverability of the excess cost and during the year concluded there was no further value to the goodwill. As a result, additional amortization is provided to reduce the carrying value to Nil.

## Note 1 - Significant Accounting Policies *(Continued)*

### (d) Foreign currency translation

Monetary assets and liabilities are translated at the rates of exchange at the balance sheet dates. Non-monetary assets and liabilities are translated at the rates in effect at the dates the assets or liabilities were acquired. Revenues and expenses are translated at the average rates of exchange during the month in which they are recognized. During the year, there were no gains or losses.

### (e) Leases

The corporation accounts for leases that transfer significant benefits of ownership, as capital acquisitions and corresponding liability obligations. Leases that do not transfer significant benefits of ownership are classified as operating leases.

### (f) Revenue recognition

The corporation recognizes revenue from software development agreements:

(1) **Royalty guarantees** - when the corporation has reached pre-determined milestones of the development and is mutually agreed upon by all parties.

(2) **Additional royalties** - Royalties in excess of any royalty guarantees are recognized upon receipt of documentation of unit sales.

### (g) Development costs

The corporation capitalizes all costs to work in progress directly related to the development of project software for unattained milestones. These costs include all salaries, consulting fees, administration and amortization of capital assets used directly in the development of specific project software. Any incidental revenue, including interest, reduces the amounts capitalized.

The corporation charges these costs to operations during the same period as the related royalty guarantees generate revenue.

The corporation also expenses any portion of the deferred costs when recoverability is not foreseen as a project is abandoned.

### (h) Loss per share

Loss per share figures are based on the weighted number of shares outstanding in the year.

**Note 1 - Significant Accounting Policies** *(Continued)*

(i) Financial instruments

The fair value of financial instruments is determined by reference to various market data and other valuation techniques as appropriate. The corporation's financial instruments consist of cash, accounts receivable and accounts payable. The fair value of financial instruments is not estimated by management to be materially different from the carrying value.

**Note 2 - Goodwill**

| | 1998 | 1997 |
|---|---|---|
| Excess of cost over net identifiable assets acquired on reverse takeover | $ 330,000 | $ 330,000 |
| Less: accumulated amortization | (198,000) | (132,000) |
| impairment of goodwill | (132,000) | - |
| | $ - | $ 198,000 |

**Note 3 - Capital Assets**

| | 1998 | | |
|---|---|---|---|
| | Cost | Accumulated Amortization | Net Book Value |
| **Development equipment:** | | | |
| Computer hardware | $ 699,145 | $ 305,223 | $ 393,922 |
| Computer software | 151,588 | 144,088 | 7,500 |
| Sound and audio equipment | 44,793 | 29,001 | 15,792 |
| | 895,526 | 478,312 | 417,214 |
| **Other:** | | | |
| Office furniture and equipment | 146,747 | 43,796 | 102,951 |
| Leasehold improvements | 82,376 | 61,771 | 20,605 |
| | 229,123 | 105,567 | 123,556 |
| | $ 1,124,649 | $ 583,879 | $ 540,770 |

Note 3 - Capital Assets *(Continued)*

| | 1997 | | |
|---|---|---|---|
| | Cost | Accumulated Amortization | Net Book Value |
| Development equipment: | | | |
| Computer hardware | $ 506,295 | $ 177,724 | $ 328,571 |
| Computer software | 136,588 | 96,324 | 40,264 |
| Sound and audio equipment | 44,793 | 22,233 | 22,560 |
| | 687,676 | 296,281 | 391,395 |
| Other: | | | |
| Office furniture and equipment | 66,598 | 28,078 | 38,520 |
| Leasehold improvements | 82,376 | 45,296 | 37,080 |
| | 148,974 | 73,374 | 75,600 |
| | $ 836,650 | $ 369,655 | $ 466,995 |

Note 4 - Shareholder Advances

The advances from shareholders are unsecured, non-interest bearing and without fixed payment terms.

## Note 5 - Share Capital

Authorized:
Unlimited Class A common voting shares

Issued and outstanding:

| | 1998 | | 1997 | |
|---|---|---|---|---|
| | Shares | Amount | Shares | Amount |
| **Balance,** beginning of year | 9,208,271 | $ 1,788,077 | 8,832,271 | $ 1,647,470 |
| Issued | | | | |
| - for services | - | - | 50,000 | 25,000 |
| - private placements | 2,250,000 | 337,500 | 100,000 | 100,000 |
| - on exercise of stock options | - | - | 226,000 | 62,908 |
| | - | 2,125,577 | | 1,835,378 |
| Share issue costs | | | | (47,301) |
| **Balance,** end of year | 11,458,271 | $ 2,125,577 | 9,208,271 | $ 1,788,077 |

### (a) Escrowed common shares

As at December 31, 1998, there are a total of 3,004,166 (1997 – 3,420,833) shares that remain held under escrow agreements dated June 5, 1996. The escrow agreement provided that 1,250,000 escrowed shares be released as to one-third thereof upon the first, second and third anniversaries of the completion date of the reverse takeover transaction dated June 5, 1996. There are 416,666 shares remaining to be released under the first agreement. The remaining 2,587,500 shares will be released from escrow on the basis of one escrowed share for each $0.25 of cash flow of the corporation.

During the year, 416,667 shares were released from escrow based on the June 5, 1996 anniversary.

**Note 5 - Share Capital** *(Continued)*

(b) Stock options

As at December 31, 1998, the corporation has outstanding stock options issued to directors, officers and employees, convertible into common shares on a one for one basis, as follows:

| Number of Options | Exercise Price | Expiry Date |
|---|---|---|
| 225,000 | $ 0.50 | June 2001 |
| 135,000 | $ 1.00 | June 2001 |
| 145,000 | $ 1.00 | July 2002 |
| 145,000 | $ 1.12 | July 2002 |
| 560,000 | $ 0.40 | March 2003 |

**Note 6 - Commitments**

The corporation has entered into premises operating lease agreements, expiring in the year 2000, with estimated annual lease payments of $90,000.

**Note 7 - Income Taxes**

At December 31, 1998 the Corporation has losses forward of approximately $1,570,000 for income tax purposes. These losses begin to expire in the year 2003. No provision has been made for the benefit of these losses as there is no certainty that these losses will be utilized. In addition the tax value of equipment exceeds the book value by $100,000.

The corporation's revenue is in the form of royalties which are subject to certain foreign withholding taxes. Foreign withholding taxes amounted to $51,848 in 1998. Additional tax expense results from a change in the amount recoverable for scientific research tax credits of $48,475.

**Note 8 - Related Party Transactions**

During the year, the company purchased, at estimated fair value, computer equipment amounting to $64,000 from a company owned 50% by one of the corporation's major shareholders.

### Note 9 - Uncertainty due to the Year 2000 Issue

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date.

The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure, which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the entity, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.